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CHILE'S STRUCTURAL ADJUSTMENT: RELEVANT POLICY LESSONS FOR LATIN AMERICA[1]

by

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ABSTRACT

This 'aper presents an overview of the Chilean adjustment experience of the past two decades. After reviewing the main policy issues during the period, the paper submits a discussion about the different phases that characterized the application of key economic reforms in the areas of macroeconomic management, market deregulation, trade opening and the financial and social sectors. The paper discusses the sequencing of policy measures and the likely implications of the chilean experience for other Latin American countries in need of structural adjustment. The paper argues that the adjustment process envisaged by most developing countries is necessarily lengthy, given that two successive phases should be typically distinguished --corresponding to stabilization and structural adjustment-- characterized by different emphasis in terms of macro and microeconomic policies. The paper also argues that appropriate labor market policies should be adopted early in the process, to facilitate the industrial restructuring and diminish the unemployment impact. Also, it indicates that proactive and reactive social policies are essential ingredients to smooth the transition and attaining the political sustainability required for any reform package.

I. INTRODUCTION

During the present world recession, Chile figures among the most dynamic economies in the world, and a very noticeable exemption in Latin America. Twenty years ago, however, Chile was a typical LDC characterized by poor growth, substantial macroeconomic imbalances, low investment rates and a large and inefficient public sector, as well as by protective policies addressing specific industries and markets, producing a highly distorted resource allocation. The average per capita annual growth rate in the period 1900-1989 was approximately 1.3 percent, (Ferraro and Riveros, 1994), while inflation went from an average of more than 25 por ciento p.a. in the 1960s to a notable hyperinflation process in the early 1970s. In contrast, during the past eight years, the average per capita growth rate has been almost 5.5 percent p.a., with yearly inflation rates averaging less than 15 percent, and notably declining during the 1990s. Meanwhile, the investment rate in the 1990s has reached up to more that 25 percent of the GDP, which is substantially above historical averages, while the fiscal deficit over the past eight hasturned into a surplus, export growth is solid and the balance of payments situation appears quite sustainable. After being a typical inward-looking economy, Chile has become one of the most aggressive new exporting economies, has resisted well the recent negative financial developments after the Mexican devaluation, and it has become a top attraction for foreign investors in natural resources-based industries, as well as manufacturing. With fairly low unemployment and notable macroeconomic equilibria, Chile enjoys a solid base from which to confront the challenge of improving social conditions.

Some central lessons may be drawn from the Chilean economic experience for other Latin American countries seeking stabilization and adjustment. Nonetheless, important qualifications are indispensable with regard to the idea of replicating the chilean experiment, particularly considering the timing and political conditions that prevailed during the Chilean reforms.. Also, the significant social and political costs involved in attaining a sustainable structural adjustment, which would normally demand broad political consensus, should be carefully considered in the political economy context. Overall, the chilean experience reveals crucial lessons regarding the phasing and strategy of economic reforms. Two phases need to be distinguished in the adjustment process, featured by different emphasis on macro and microeconomic policies. First, in order to reduce inflation and improve the market's allocative efficiency, it is the need for stabilization, elimination of the most distorting trade restrictions, and reduction of the economic size of the State. Second, structural adjustment measures need to be adopted subsequently, particularly through strengthening privatization strategies, adopting labor market reforms, as well as export promotion policies and measures aimed at reinforcing macroeconomic equilibria. The chilean experience also indicates that reforms addressing the fluidity of the labor market and the effectiveness and efficiency of the social policy are paramount. Higher and persistent unemployment, and an unattended increasing poverty problem, resulted in Chile from the lack of appropriate labor market and social policies during the 1970s reform phase. The reform phase of the post 1985 period, on the contrary, was effectively accompanied by measures aimed at making the functioning of the labor market more fluid, and at building up more efficient social services. As a result of these measures, economic growth in the late 1980s and early 1990s has led to substantially lower unemployment, increasing real wages and labor productivity, and dropping poverty levels.

This paper reviews the major stylized facts of the Chilean economic transformation that took place over the past two decades and examines the three major phases of that transformation: the stabilization phase (1974-1982), the financial crisis and the post 1985 structural adjustment phase. It discusses the implications of the Chilean experience for countries in need of stabilization and structural adjustment, especially with regard to the sequencing and coordination of economic policies. The paper concludes that a possible replication of the Chilean experience needs to be carefully considered at the light of the prevailing internal and external conditions in any given country. The paper begins with a discussion of the economic scenario of the 1970s and the most fundamental economic transformations of the first phase of the adjustment (section two), followed by a look at the financial crisis and at the policy approach used during the post-1985 period (section three), the implications of this adjustment experience for other Latin American countries (section four) and a summary and conclusions (section five).

2. THE ECONOMIC SCENARIO OF THE 1970s

2.1 The Socialist Experiment (1970-73)

The government of Dr. Allende pursued radical changes aimed at attaining lower inflation, a better income distribution and higher growth. Against the backdrop of the import substitution strategy Chile had followed since the 1940s, the chief elements of policy were a high level of state intervention in productive affairs, and expansionary wage, fiscal and monetary policies. For instance, during 1971 the fiscal deficit increased from 2.7 to 10.7 percent of the GDP, and credit from the Central Bank to the public sector increased by more than 110 percent (Table 1). On the external front, and partly as a result of a sharp drop in world copper prices -- Chile's major export at that time -- international reserves dropped dramatically (from \$390 million in 1970 to \$161 million in 1971) and a trade balance surplus of \$156 million in 1970 became a deficit of \$16 million in 1971. The policy response to these external shocks fostered further distortions: for instance, significant quantity controls on imports were added to traditionally high tariffs rates, while real wages were allowed to grow in about 22 percent in one year[1], at the same time that real interest rates were rising.

The overheating of the economy created during 1971, created serious economic problems in the two following years. Maintenance of a progressive and revolutionary reputation was considered more important than reducing economic disequilibria (Larrain & Meller, 1990). In a typical Latin American fashion, the fiscal situation further deteriorated and no effort aimed at reducing expenditures was ever implemented. On the contrary, the need for transferring resources to a growing number of public enterprises --working in a scheme of low fixed nominal prices-- in combination with a dramatic drop in tax collection and growing inefficiency throughout the entire public sector, created additional pressures on fiscal accounts. The fiscal deficit expanded dramatically from 10.7 percent of the GDP in 1971 to almost 25 percent in 1973 (Table 1, col.(7)), while the total quantity of money increased by 152 and 363 percent in 1972 and 1973 (Table 1, col.(5)), and the yearly inflation skyrocketed to 260.5 and 605.1 percent in these same years (Table 1, col.(4)). The productive sector --heavily intervened by the government and suffering from distorted input and output prices-- was characterized by a soaring black market and was both unable and unwilling to provide a supply response to any demand-driven policy.

The evidence of economic mismanagement in 1970-73 is the combination of worsening deficits in both the fiscal and the external accounts, and slow economic growth. As heavier controls imposed by the government did not stop the increase in imports, and as exports did not show any positive evolution, partly due the drop in copper prices, the current account deficit increased from $189 million in 1971 to almost $400 million in 1972 and $270 million in 1973. In addition, the real GDP fell at rates of 1.2 and 5.6 percent respectively in 1972 and 1973, a drop which was also accompanied by a steady decline in investment from 16 to 8 percent of the GDP in 1970-73 (Table 1, col. (6)). Paralleling these

[1] See the series presented in Table 3, col. (2), corresponding to INE (National Bureau of Statistics)'s Real Average Wage Index. In the case of manufacturing (col.(3)), this real increase was close to 10 percent, similar to that of the hourly labor incomes for the urban informal sector (col. (4)). The series in col. (5) (Table 3) corresponds to the hourly labor cost expressed in US dollars; hence, the real increase of almost 60 percent in this indicator between 1970-71, could be partly associated to the increase in the nominal exchange rate (brokers'market) of 50 percent in that period.

developments on the real side, a further decline in average real wages in 11.3 and 38.6 percent took place in 1972 and 1973, respectively[2] (Table 3, Col. (2)).

Instead of adopting sound adjustment policies, the government insisted that economic problems were due to a plot organized by the private sector and the political foreign intervention. It further insisted on seizing private firms and practicing expansionary monetary and fiscal policies. This strategy exacerbated the political turbulence, already high in 1973 due to severe product shortages across markets, and a critical and active political opposition. Although unemployment was fairly low thanks to public enterprises[3], and in spite of the effort to keep wages in line with the price inflation in 1972 and 1973, through indexation mechanisms, the dramatic fall of real wages (Table 3) contributed to intensify the opposition from unions. Facing an active opposition from conservative parties, and having lost the support of key political and social forces which had supported the Administration in its beginnings, the Allende overthrowing was the tragic conclusion of a generalized crisis.

2.2 The Economic Reforms of the 1970s

The economic scenario created in the 1970-73 period in Chile constitutes a typical story of many Latin American countries in different periods during the post-WWII era. Independently from the heavy political emphasis of the socialist government of Dr. Allende, many countries in the region have typically suffered from an excessive fiscal expansion, distorted trade regimes, intervened financial markets, growing state intervention in production, misaligned relative prices, a relatively high hidden unemployment, and centrally fixed nominal wages. Although inspired in the idea of improving the income distribution and achieving a better resource allocation by means of a greater government intervention, these policies have instead resulted in high inflation, recession and soaring political

[2] See Table 3. Minimum Wages also dropped in both years in 5 and 50 percent, respectively, while manufacturing wages dropped by 11 and 39 percent. An additional source (The University of Chile's Labor Force Survey) shows a decline in informal sector wages by 28 percent only between 1972 and 1973, after a small increase of almost 3 percent between 1971-72, a result which is likely due to the fact that this survey only represents the urban Santiago Area. In contrast, total (dollar) labor costs (i.e. including fringe benefits) show a drop in 1972 and 1973 by 3 and 45 percent respectively (Table 3, column (5)).

[3] Unemployment rates reached the lowest historical level in 1972 (3.1 percent), and increased mildly to 4.8 percent in spite of the significant drop in GDP occurred during 1973, a result mainly due to a notable increase in public sector employment.

turbulence. Therefore, the condition of the Chilean economy in 1973, can be adopted as a classical one for an economy in profound need of both stabilization and adjustment.

The post 1973 military government embarked upon intense economic reforms aimed at improving efficiency in the framework of an open economy.[4] The adoption of fiscal restraint and the privatization of public firms were the main policy instruments in this regard, as they allowed the recovery of the real sector through a better guidance of markets by relative prices. The loosening of traditional wage and employment controls --both legal and administrative-- was another key reform area, as were deregulation of product markets, and the trade and financial openings. As a reallocation of productive resources could not work well on the basis of misaligned prices, the emphasis of the government immediately during the post 1973 period, was not so much on achieving structural reforms allowing for higher productive efficiency, but in reducing the presence of high inflation and restoring the allocative role of relative prices. It is important to say that, with no previous adjustment events of the magnitude foreseen in Chile after 1974, the economic policy design did not rely upon any former experience, being practically guided by general prescriptions of economic theory and the neoclassical paradigm.

2.3 The Stabilization Program

The Chilean economic reforms were initiated with a sharp stabilization effort in 1975-1976. A first phase of the stabilization program took place during 1974, when measures aimed at reforming central government institutions, as well as at privatizing firms previously taken over under the Allende regime, were quickly implemented. By 1975, inflation was still above 300 percent p.a. (Table 1, column (4)). To combat it, a dramatic drop in the fiscal deficit was achieved in one year,[5] accompanied by a tighter monetary policy. As a result, inflation was significantly curbed between 1975 and 1978, and it continued dropping until 1981 thanks to the implementation of a nominally fixed exchange rate which, however, fostered serious problems with regard to the allocation of investment. The creation of a fiscal surplus was paramount to the success of the stabilization program, specially the adoption of market-oriented policies regarding public enterprises and the implementation of an across-the-board reduction in fiscal expenditures.

[4] See Edwards & Edwards (1987), Walton (1985) and Corbo (1985).

[5] The fiscal deficit (measured against GDP) declined from 24.7 to 10.5 between 1973 and 1974. A further drop to 2.6 was achieved in only one year, between 1974 and 1975. All this adjustment took place basically through reduction in public sector expenditures.

The stabilization program produced a severe drop of the aggregate demand, leading to a real GDP decline of almost 13 percent in 1975 (Table 1, col.(1)), thereby also involving a high social cost. In fact, the unemployment effect of the across-the-board reduction in aggregate demand was important: the rate of open unemployment reached to more than 26 percent in 1976 (Table 3). The drop in real wages, another key outcome of the 1975-76 stabilization effort, was also significant. Although the real minimum wage doubled between 1973 and 1975-76 (Table 3, Column (1)), all other real wage indicators (average, manufacturing and unskilled labor) experienced a severe drop during the stabilization period (Table 3). In addition, the stabilization effort seriously affected long run growth due to its negative effects on investment and wealth (Edwards, 1985).

2.4 Trade Reforms

Chile, like most Latin American countries, largely pursued industrialization based on the creation of a sizable import substituting industry. High trade barriers, considerable inefficiency, discrimination against agriculture and growing government intervention in economic affairs were major outcomes of that policy (Corbo, 1985). Paradoxically, employment growth in manufacturing was negatively affected under this policy approach (Corbo & Meller, 1984), and labor market segmentation was made deeper due to the need for labor protection and strong unionization. Moreover, the failure to achieve an efficient industrial sector demanded progressively higher protective barriers, leading to an average tariff rate as high as 105 percent by 1973 (Torres, 1982).[6]

The post-1973 reform aimed at sharply reversing import-substitution by means of a far-reaching opening up. The trade opening was expected to bring more investment and employment in the longer run, in productive sectors with comparative advantages in the international trade. However, the measure was, at the time, chiefly inspired in the need of attaining lower inflation. Nonetheless, the observed failure in achieving higher exports and more rapid growth of labor-intensive industries in 1974-1982 can be traced to two drawbacks: (1) the tariff reduction program did not start off with a very precise target, shifting several times the final tariff being pursued and creating uncertainty in investors[7]

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[6] Ad-valorem tariff rates ranged from 0 to 750 percent, while import prohibitions applied to 187 tariff classification, a 90 day import deposit requirement was in effect for 2,800 others and 2,300 categories required special approval from the Central Bank.

[7] Initially, tariffs were planned to reach an average 60 percent by 1977. By 1975 average tariffs had reached 57 percent, while almost all quantitative restrictions were eliminated. In a second stage, a new structure with tariffs ranging from 10 to 35 percent, was achieved during the third quarter of 1977.

(Riveros,1986); and, (2) the exchange rate was used as a stabilization device, particularly after 1978, producing a notable overvaluation which negatively affected expectations and export industries[8] (Corbo, 1985b; Edwards & Edwards, 1987). In fact, the exchange rate was nominally fixed between 1979 and 1982, in the basic aim of reducing the inflation rate which, despite the fiscal and monetary disciplines already in place, was in 1979 still around 39 percent. Besides, amid high domestic interest rates and a growing peso appreciation, the economic authority decided to further open the capital account; in a period of a rapidly expanding world credit market, the immediate result was a heavy external indebtness[9]. In addition, to the macro imbalances generated by the debt problem (Edwards & Edwards, 1987), this policy allowed large firms to adopt more capital-intensive techniques, thereby negatively affecting employment growth in expanding activities.

2.5 Privatization and Public Sector Reforms

Another key set of reforms after 1973 aimed at reducing the economic size of the State through reducing real government expenditures and privatizing public firms. The share of public firms in the GDP, which reached 14 percent in 1965, was as high as 39 percent in 1973 (Hachette & Luders, 1987). Another indicator of the growing size of the State during those years is the relative importance of total public employment--i.e., including civil service, local governments and public firms-- which reached about 14 percent of total employment in 1973 (likely about 36 percent of total formal employment), after having grown 38 percent between 1970 and 1973.[10]

To reduce the economic size of the State, a major privatization program was implemented, concurrently with policies aimed at achieving more efficient services and a smaller state

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Finally, a more radical reform allowed the average nominal tariff rate to reach an uniform 10 percent by late 1977.

[8] After unification of the exchange rate in 1973, an initial 300 percent devaluation and a series of mini-devaluations, the real exchange rate reached a peak value by late 1975. Subsequently, the real exchange rate declined sharply concluding in a 10 percent appreciation in june 1976. Real peso appreciation continued being used as a stabilization device through a system of devaluations that allowed for certain real appreciation. However, inflation did not drop as expected. From June 1979 a nominally fixed exchange rate was implemented and maintained until mid-1982, when dramatic peso devaluations took place in the wake of the world recession.

[9] The total external debt increased from US$8.5 billion to 17.1 billion in the period 1979-82.

[10] In 1970 about 10 percent of the labor force was employed in the public sector. This proportion declined to 7 percent by 1980 and to about 5 percent in 1988 (Hachette & Luders, 1987).

sector. Firms expropriated during Allende's socialist experiment were immediately privatized: by the end of 1974, 202 out of 259 firms had been returned to their owners (Larrain, 1988). Most of these firms were operating at substantial losses, and a condition for returning them to their original owners was that they had to assume all accumulated debts and waive any possible damage claim against the government. Additionally, a sale of assets owned by the State was quickly implemented with most bank shares (US$ 171 million) and a significant part of the industrial property (US$ 58 million) being cold by 1975.[11]

Since parastatals' share in GDP dropped only from the 39 percent seen in 1973, to a still high 24 percent in 1981, an additional privatization effort took place at the time of the crisis of the 1980s. Of Chile's 100 largest non financial enterprises, according to book value, the companies in which the state owned 50 percent or more of the shares at the end of 1976 accounted for 79 percent of total assets and 81 percent of total worth (IBRD, 1979). Moreover, by 1981 the state controlled all of the top ten enterprises in the country (Copper, Steel, Telephones, Energy, Coal Mining etc.) raising questions about the sustainability of the adjustment effort.

2.6 Markets Deregulation.

A top priority of the post-1973 reform program was the improvement of resource allocation through an efficient free market system. Hence, and countering a historical tradition of price fixing, price regulation was almost completely eliminated at once[12], including control of interest rates and the several quantitative constraints existing for capital market operations. The increased market competition faced the private sector with the need of improving productive efficiency, causing several bankruptcies during the transitional period.

The wave of deregulation also reached the labor market, which was considered a crucial area after a period of acute government intervention and union activism. A partial liberalization in wage setting schemes was achieved, and adjustment measures aimed at eliminating overemployment were also encouraged by the government, particularly in the case of public firms. However, more than attempting the replacement of traditional labor market regulations by measures providing for more flexibility, policies measures aimed at simply dismantling the institutional arrangement of the labor market. Hence,

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[11] This was a year of unprecedented economic decline (GDP felt by 12.9 por ciento), thereby originating unprofitable sales. At the same time, firms were sold below their book values, although still above their stock market value [Larrain, 1987].

[12] After an era in which more than 3,000 prices were set and eventually controlled by the authority, only 33 commodities remained under control, most of them utilities.

collective bargaining and union activities were eliminated simultaneously, while job security regulations, which aimed at making labor dismissals relatively more expensive, were also eliminated: after 1973 massive labor dismissals required only a simple administrative authorization from the government. Moreover, unions were de facto eliminated, their leaders being hand-picked by the government itself. Therefore, the private sector was given full power to implement its preferred employment-wages strategy.

The absence of a legal framework for the labor market during most of the 1970s was, nonetheless, a factor which fostered unfavorable expectations in the private sector. During the entire period 1973-1979 no new legal provisions governed labor relations, inter-alia, in connection with procedures for wage bargaining, job security, the right to strike, negotiation of working conditions and union activities. After a long history of labor market intervention, and as private employers may have envisaged a return to an environment characterized by confrontations with the unions, the legal vacuum of 1973-1979 did not favor a more labor-intensive production technology. On the other hand, minimum wages and non-wage cost regulations were upheld by the military regime, and a wage indexation system was implemented, although with little real effects given the lack of appropriate enforcement [Edwards & Edwards (1987), Riveros (1986)]. These particular interventions were, however, apparently reason enough to foster segmentation of the labor market, making wage adjustment and the inter-industry labor mobility far more difficult (Riveros & Paredes, 1990).

The social cost of the adjustment, as indicated by alternative poverty measures, the unemployment rate, the observed drop in real wages and the deteriorating income distribution, was notably high. The particular political situation in which the adjustment program was implemented was the key to attaining such sustainable reforms and to avoiding policy reversals even in the presence of high social cost. During this first phase of the adjustment, not enough proactive or reactive labor and social policies were implemented. The only important one was the creation of an unemployment subsidy which operated through public works. However, no special training or retraining programs were in place, nor any employment information system that would have allowed for a higher labor mobility. The fiscal restraint needed to attain the stabilization target, at the same time, created strong financial pressures on social sectors which, in the absence of specific measures aimed at improving their targeting criteria, did not fulfill the role of an efficient reactive program.

3. THE 1982 FINANCIAL CRISIS AND THE POLICY RESPONSE.

The 1982-1984 financial crisis brought another sharp economic decline in Chile, amid serious balance-of-payment problems. Afterwards, due to sharp devaluations of the exchange rate, combined with expenditure reduction and other policies aimed at affecting expectations, increasing savings and promoting exports, the economy experienced a notable export-led economic expansion. The situation of the Chilean economy after the financial crisis resembles the circumstances of many other Latin American countries that, either after stabilization or in absence of inflationary episodes, are in need of structural adjustment policies to correct resource misallocation and improve balance of payment results.

Domestic economic policies introduced at the end of the 1970s created macroeconomic disequilibria which, in turn, led to unsustainable high expectations and, ultimately, to a disruption in the economic recovery initiated in 1976. These policies included the nominal fixing of the exchange rate aimed at reducing price inflation, an approach which was also used in other Latin American countries, such as Uruguay and Argentina Similarly, the full opening of the capital account under a fixed exchange rate, produced large capital inflows and heavy external indebtness. This combination of policies was still more burdensome under the binding full indexation of wages to past inflation introduced in the 1979 labor law, which resulted in increasing production costs for exporters. As the production of non tradables was being fostered by economic policy, large capital inflows financed an otherwise unsustainable expansion of private consumption and investment.

Optimism about future trends were based on the stable growth path of the economy seen since 1976, the balanced public budget, the sustained improvement in real wages after 1975 and the opening of the economy. But the financial boom of 1979-1981 was basically financed with foreign credit generously provided in an expansionary period of world financial markets, with little resources being allocated to productive investment, particularly in export-oriented activities. The magnitude of the financial crisis Chile underwent in 1982-1984 is revealed by the increase of the external debt, from 2.7 times total exports in 1979, to 4.6 times in 1983 (Table 2). As a share of the GDP, the external debt increased from 40 percent to 100 percent between the same years, while yearly interest payments increased from 3 to 10 percent of GDP. At the same time, and due to an early policy reaction to the crisis, the value of imports in real terms declined by more than 40 percent in 1982 (Table 2), triggering a GDP drop of more than 14 percent (Table 1), which was accompanied by an equally dramatic decline in aggregate investment, thereby negatively affecting future growth. The magnitude of the external shock is seen in the drop in terms of trade (from 119 in 1979 to 88 in 1983), and the increase in real (LIBOR) interest rates.[13] The sharp curtailment of capital inflows in early 1982 amplified the problem and led the economy into a deep recession in 1982-1983.

3.1 The First Phase of The Structural Adjustment of the 1980s

During 1979-1981 the authorities shifted their attention away from stabilization policies and toward structural adjustment. A series of reforms addressed traditional social policies with the aim of decentralizing administration and targeting social expenditures to the poor more effectively. In 1981 a key change to the social security transformed it from a pay-as-you-go system to one in which benefits depended only on individual contributions to a privately managed saving accounts system. This change was vital to allow for a successful privatization program given the significant potential of the social security to accumulate savings and mobilize financial resources.

A major concern raised by the adjustment already experienced in 1976-81 was the social dimension. Unemployment had not returned to its more normal 1960s´levels, despite the recovery seen in most other economic indicators by the end of the 1980s. Also, the most important criticism on the economic program was the social impact manifested in a deteriorating income distribution and an increasing poverty problem. For instance, the Gini coefficient for the income distribution had reached a value of about 0.47 in the mid-1960s, and remained above 0.51 in the period of economic recovery 1978-1982; the income share of the poorest dramatically felt from almost 13 percent (1960s) to less than 11 percent in 1980 (Table 4)[14], while the fiscal expenditure plummeted and the efficiency of the social services was wanting. It was then clear that a social strategy was needed in order to attain political sustainability for the structural adjustment phase. Also, as the labor market provided a poor response to the need of reallocating labor from contracting to expanding industries, reforms aimed at making its role more dynamic and flexible were of paramount importance in order to attain lower unemployment.

A health system reform was implemented in 1981, to increase the participation of the private sector by allowing the formation of private insurance companies providing paid health care. This reform was implemented while public sector social services (health and education) were being

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[13] See, Corbo & Sturzenegger (1988). Between 1978 and 1984 the real LIBOR increased from a level of 1.1 percent to a 6.1 percent.

[14] To this respect, see also Table 5, which shows that the share of the poorest quintile fell dramatically between 1980 and 1982, and that a noticeable improvement in it was seen only in 1988.

decentralized; the central Ministries retained responsibility for policy formulation, but not for direct administration of personnel and the budget. Hence, both education and health units were transferred to local governments, making them directly responsible for their administration and all functional outcomes. Similarly, a system of targeted assistance program, in the form of monetary subsidies for the poor, the elderly and the unemployed, was put into functioning or somewhat improved. These changes were important during the stage of recovery from the world recession, as they allowed for a better targeting of fiscal social expenditures to the poor, enabling for a more decentralized budgetary programming. Later, it would be realized that local government were unprepared to effectively manage education and health, specially because their participation in budgetary programming was lacking.

With regard to the aim of making the labor market more flexible and responsive, a new labor law was enacted in 1979, which established new guidelines for unionization and collective bargaining procedures and very much used the U.S. system as a guideline. Countering a tradition in Chile, more than one union was allowed per enterprise, wage bargaining could only be done at the firm level (reversing the tradition of industry-level wage bargaining) and the right to strike was curtailed through granting firms the right to hire temporaries. In addition, the law established the principle of voluntary affiliation to unions and banned the right of public employees to strike. Finally, the law substantially reduced job security payments, and instituted a 100 percent wage indexation to past inflation as a floor for any wage negotiation. This latter measure was singularly problematic in presence of the fixed nominal exchange rate regime prevailing in 1979-1982.

BOX 1: RESULTS OF THE 1984-85 ADJUSTMENT

	1980	1981	1982	1983	1984	1985
Public Exp.	3,158	3,602	3,528	3,485	3,766	4,343
Public Rev.	3,579	3,842	3,239	3,025	3,241	3,504
Int.Reserves	4,074	3,775	2,578	2,023	2,056	1,867
IMF credits	123	49	6	606	781	1,086

Source: Indicadores Económicos y Sociales 1960-1985, CEntral Bank (1985). Public expenditures and revenues are expressed in millions of 1976 US dollars. International Reserves and IMF credits are expressed in current US dollars.

In 1984-85 a so called "adjustment-without-recession" approach was used to face the financial and external crises. The GDP decline in 1982-83 had accumulated an almost 15 percent, while the gross investment had dropped by even more (Table 1, Cols. (1) and (6)). The policy approach --

which has been widely used in the region at different times by countries trying to get out of economic chaos-- consisted in fostering aggregate demand to encourage output growth, based on expanding fiscal outlays and the external indebtness. As a result, the external debt further increased from US$17.4 billion to US$ 18.9 billion in 1983-84 (Table 2; Fig. 5). Also, in this same period, the real exchange rate depreciated not as fast as it should be (Table 1, col. (9)) leading to a rather modest increase in exports of 7 percent (which was also notably fostered by continuously dropping terms of trade, as suggested by Fig. 6) while an import expansion of 16 percent was also taking place. Hence, the approach doubled the current account deficit, resulted in reserve losses of about 8 percent between 1984 and 1985 (which occurred on top of the 50 percent lost in 1980-83) and made profuse use of IMF credits (Box 1). Furthermore, this adjustment approach conveyed an increase in the fiscal deficit from 4.0 to 6.3 percent of the GDP, which was the highest figure in the post 1974 period, thereby leading to certain inflationary pressures in 1985 (Table 1). As figures in Box 1 indicate, the fiscal deficit was indeed associated to the increase in expenditures, rather than to dropping revenues Although economic growth occurred at 6.3 percent in 1984, the availability of external resources posited a tough constraint to the planned expansion in aggregate expenditures, making the recessionary effect even worse after that year.

What the economy needed to face the recession were sensible policies aimed at encouraging exports and at continuing with the plan of structural reforms initiated in the late 1970s. After having experienced the failure of the traditional policy approach to get the economy out if the recession, and back to a sustainable growth track, the government changed its mind regarding the macro policy management. Since 1985 it took the decision of continuing with the program started in the 1970s, based upon restrictive fiscal and monetary policies, and the increasing role of the market and the private sector in resource allocation, and the fostering of sectors with a comparative advantage in production as a key growth strategy. The government realized that the exchange rate should play a key role with regard to developing a more dynamic export base, and that the need of promoting investment, both domestic and external, required providing adequate signals to investors on the institutional character of the economy and its expected evolution.

3.2 <u>The Second Phase of the Structural Adjustment</u>

After 1985, the adjustment program pursued the maintenance of a high real exchange rate, introduced a program to continue the privatization of public firms and control of fiscal expenditures, created mechanisms to convert external debt into domestic investment,[15] gave specific incentives to exports, and strengthened a system to target social expenditures to the poor. The economy resumed strong growth (more than 5.5 percent p.a. in 1986-1988), led by a large expansion of non-traditional exports, and a significant increase in private investment. A policy aimed at introducing a systematic real exchange rate devaluation (Table 1; Figure 1), accompanied by other standard export promotion policies, was a key element in attaining a strong economic growth, thereby also resulting in declining unemployment rates and expanding average real wages (Table 3 and Figure 4). The latter outcome was strongly linked to the increase in labor productivity associated to the expansion of new export industries. Fiscal and monetary discipline --which would be ratified by the end of the decade by transforming the Central Bank into an autonomous institution-- resulted in dropping inflation rates (Table 1 and Figure 3) at least until 1988. As a matter of fact, inflation behaved rather erratically after 1985 and it has shown a notable persistence which produced a level still above 27 percent in 1990[16].

A key element in promoting exports was introducing a sharp devaluation of the real exchange rate (Figure 1). The increase in the relative price of tradable to non-tradables, produced substantial factor mobility towards export and import substituting industries, producing positive trade balance results. The increasing capital inflow and the expanding domestic investment, jointly with a growing and more efficient financial sector, enabled a satisfactory intersectoral capital mobility and a substantial productive expansion. A well functioning labor market allowed for the labor reallocation needed after the recessionary shock, as suggested by the notable drop in unemployment seen between 1986 and 1990 (Table 3, Col.(6); Fig. 4). As it has been shown (Paredes & Riveros, 1993), the employment-output elasticity structurally increased after the labor market reforms of the early 1980s. These reforms fostered greater inter-industry labor mobility and higher a flexibility, since the new job security norms made the hiring and firing processes less expensive, allowing for effective reentry of the unemployed. The reaction of wages to observed developments with regard to unemployment was sluggish; average wages first dropped between 1986-87, increasing afterwards at 4 percent p.a. (Table 3, Col. (2)). In manufacturing, wages increased since 1985 at a similar yearly rate. Also, the real minimum wage grew at 9.5 percent p.a. after 1987, while the wage of unskilled labor --characterized by

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[15] Which has yielded a drop in the total external debt in more than 10 percent.

[16] A factor underlying the persistence of the inflationary record is the existence of widespread indexation mechanisms, which comprehend all financial obligations and rental prices, thereby introducing downward inflexibility in output prices. Until recently, and in spite of the conservative macro and fiscal framework in place, the chilean inflation has remained well above the international inflation.

a real cut by half between 1982-87-- increased by an average 12 percent p.a. after this years. It is also interesting to note that total labor costs also increased at 11 percent p.a. after 1987[17]

The privatization strategy fulfilled a key role during this second phase. As a result of the debt crisis of 1982-84, the financial system was in a very difficult situation. Largely indebted and depicted by a very low public credibility, most of the banks were unable to produce the capital mobility needed to start a meaningful recovery. However, a market solution, which would have implied the bankruptcy of important banks indebted beyond their capital, would have produced a clear negative impact on the credibility and viability of the chilean economic model as a whole. Therefore, solving the debt problem of the banking system and, in several cases, the actual property condition of financial institutions, were considered a top priority. This gave rise to a policy scheme by the issuing of shares was implemented to be sold openly to small investors. This capitalization strategy --literally, a "rescue" operation-- originated a huge long term debt of most of the beneficiary banks with the Central Bank,

BOX 2: STRUCTURE OF CHILE'S SOCIALSPENDING

	Health	Education	Housing	S.Security	Other
1970	18.0	41.5	9.6	26.9	3.9
	(1.6)	(3.8)	(0.9)	(2.5)	(0.4)
1975	16.3	34.8	8.6	25.9	14.4
	(1.7)	(3.6)	(0.9)	(2.7)	(1.5)
1980	14.0	33.5	5.5	29.5	17.5
	(1.4)	(3.4)	(0.6)	(3.0)	(1.8)
1985	7.1	24.6	4.4	41.3	22.5
	(1.1)	(3.8)	(0.7)	(6.3)	(3.4)
1989	7.5	27.7	6.0	49.4	9.4
	(2.2)	(2.8)	(1.1)	(6.7)	(1.1)
1990	7.5	27.7	6.6	52.4	5.8
	(2.1)	(2.7)	(1.1)	(6.9)	(1.1)
1991	8.5	25.0	7.7	49.8	9.0
	(2.4)	(3.1)	(1.3)	(6.7)	(1.2)
1992	9.3	25.4	8.5	47.2	9.6
	(2.6)	(3.1)	(1.3)	(6.6)	(1.2)

Sources: Central Bank (Boletín 796; 1994); Taller de Coyuntura 1993., Politica Fiscal (J. Yañez) The series are not directly comparable after 1989. Figures are expressed as a proportion of the social fiscal expenditure. Between brackets, as a proportion of the GDP.

[17] As explained above, total labor costs include fringe benefits paid to unskilled labor in manufacturing. The drop of the unskilled wage vis-a-vis the average wage seems to support the idea presented by Robbins (1995) in this same volume, in the sense that the trade opening resulted in an expansion in the skilled/unskilled wage gap. However, the strong growth in labor costs after 1985 (at an average of 7.6 percent p.a.) vis-a-vis the expansion shown by the average real wage in the same period (3.7 percent p.a.) raises questions with regard to this observed result. (see, also, Table 3 Col (7)).

which provided the credit to purchasers of the new shares. This "popular capitalism" solved the property problem as, in the case of largely indebted banks, it was politically unpalatable to return all of the now more available banking assets to large private interest groups.

By 1985 many large enterprises still remained in state hands. The decision of initiating a radical transfering of most of them to private hands was based upon the need of reducing their likely negative impact on fiscal accounts. More importantly, however, were the needs of improving their productive efficiency, and giving adequate signals to foreign creditors about the transformations being implemented and the indisputable leading role allotted to the private sector in the economic strategy. Large public enterprises were sold either through open stock market operations, or by means of direct allocation of shares[18]. Energy was one of the sectors privatized through a direct selling of shares to small investors, in order to which a longer term credit line was instituted by the government. By the same token, the telephone company, the steel industry, coal mining and other secondary industries still in State hands at the beginning of the 1980s, were transferred to the private sector. At the same time, policies addressing the need of attracting foreign capital were implemented, specially by allowing the transformation of external debt into external investment through debt-equity swaps operations managed by the Central Bank[19]. In sum, the Chilean economy introduced changes in the areas of state property and external debt management, which allowed continuing with the implementation of a macro framework aimed at encouraging growth and exports, at the same time of giving a more prominent role to the private sector in resource allocation.

3.4 The Distribution Effects of the Adjustment Program

The economic reforms of the 1970s exerted major effects in terms of the labor market. Open unemployment increased from the average 6 percent of the labor force seen in the 1960s, to more than 16 percent during 1974-1981 (Table 3).[20] A major cause of the higher unemployment of 1974-76 was the productive shock derived from both the stabilization program of 1975-76 and the initial phase

[18] This was, for instance, the case of public employees choosing to get shares of the Energy Company (ENDESA) using their severance funds.

[19] Chilean debt bonds were marketed at that time at about 50 percent of their face value.

[20] This average includes unemployed individuals participating in Emergency Employment Programs (EEG). If EEG members are excluded, the average unemployment in 1974-81 reaches about 13 percent of the labor force.

of the opening of the economy. It is considered (Riveros, 1985) that the reduction in public sector employment and the higher growth in labor force participation were also major factors underlying the unemployment increase seen in this period. The government reacted by creating emergency employment programs in 1976, which provided modest money subsidies for the urban joiblunemployed, contributing to reduce the social impact of open unemployment, but also to boost participation of secondary labor force.

Even in presence of a strong economic recovery in 1976-1981, open unemployment remained high relative to the historical standard (Table 3). To a large extent, the persistence of abnormal unemployment levels relate to the substantial shift in production that was occurring in the economy as a consequence of the open trade regime. As a substantial skill mismatching prevailed in the labor force and no institutional mechanism was prepared to provide with a proactive answer (Riveros, 1986), transitional and mismatch unemployment were high. At the same time, an intense change towards capital-intensive techniques was taking place in production, particularly in manufacturing and services, leading to a structurally higher open unemployment. This latter outcome derived from the wrong signals emanated from the lack of suitable definitions on the institutional environment that was going to prevail for the labor market after a period in which the law had been virtually suspended. The financial and productive crisis of 1982-84 produced additional pressures on the labor market, on top of the already high unemployment existing in 1981[21]: unemployment rates skyrocketed, reaching as high as 30 percent of the labor force in 1983 (Table 3), a demand-driven result, since participation rates did not notably change during the recession. Later, as a result of a strong economic recovery and a more fluid labor market, unemployment sharply dropped since 1985 leading to a level close to the natural rate in the early 1990s.

A related labor market outcome was the drop in real wages in the 1970s and early 1980s. Real wages declined by about 50 percent in 1972-75 (Table 1 Col. (2)) and notably recovered until 1981 at an average rate of 9.5 percent p.a., an outcome which took place regardless of the presence of higher unemployment (Table 3). Average real wages again declined very dramatically between 1982 and 1983, partly as a result of the productive recession and growing unemployment, but also due to the elimination of the legal wage indexation system established in 1979. Between 1982 and 1985, real wages further declined along with unemployment, the index reaching a value of 93 this later year (Index 1980=100), which compared poorly with the level of 109 seen in 1981. It is important to note that this latter level

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[21] It is important to insist in that this rate more than doubled the historical average and that it was present after five years in which the GDP grew at an average per capita rate of more than 5.5 percent p.a..

was still below the 1970 value. After 1985, average real wages increased slightly, more notably in the case of manufacturing as real wages resembled the observed behavior of labor productivity. The informal sector real wage (Table 3, Col.(4)) shows a marked decline in 1972-75, but a much more marked increase than average wages until 1982. Afterwards, the behavior of both series (average wages and informal sector wages) is quite different: average wages dropped by 4 percent in 1982-87, while informal sector wages declined by almost 50 percent. In the period 1987-90, on the contrary, informal sector wages increased by 42 percent in real terms, while average wages did it in only 12 percent. It is important to note, in this respect, that the informal sector is mostly made by selfemployed, whose wages situation is clearly more sensitive to open unemployment.[22]

According to the Gini coefficients and the share of the poorest 40 percent in total income, the distributive situation markedly worsened during the adjustment of the 1970s, at least comparing 1980 with the prevailing situation in 1960/65 (Table 4, Col.(3)). The improvement seen in the late 1980s with regard to the Gini coefficients for the family income distribution was notable, closely resembling the path of reduction in open unemployment: the Ginis (Table 4), increased notably in 1974-1976 to decline only slightly afterwards (between 1976 and 1979).[23] However, the income share of the poorest 40 percent did not experienced the dramatic improvement seen during this period in distributive indicators, given that income share of the poorest was similar in 1989 to that prevailing in 1981. Nonetheless, the situation of the poorest 40 percent recovered during the 1980s; as the fiscal social expenditure declined between 1984-90 (Table 4, Col.(5), the recovery in the income share of the poorest suggests the higher efficiency and equity impact of public expenditures after the 1980s´ social reforms.

Strikingly, during the expansionary years 1979-1981 -- and amid a financial boom -- the observed income distribution, proxied by the Gini coefficients, further deteriorated (Table 4), an outcome which would be consistent with the observed unemployment persistence and low real wage levels still

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[22] As explained in Table 3, the informal sector wage is proxied by the hourly labor income of self-employed with low skill levels. The drop in informal sector wages is a likely explanation for the declining relative wage skilled/unskilled examined by Robbins in this same volume. This result would also be suggested by comparing the average and informal sector wages presented in Table 3. However, using the same data source (University of Chile) and wage concept, it is observed that the ratio of wages skilled/unskilled (Table 3, Col (5)) has remained fairly stable in a long term context.

[23] In Table 4 we include two alternative Gini coefficients for the family income distribution. To calculate the one in col (1), households are ranked by total income, while the second one (col (2)) uses a ranking of households by their per capita income (Riveros & Weber, 1988). However, similar conclusions are reached in analyzing both coefficients. The information used corresponds to the Santiago Labor Force Survey (University of Chile).

existing during that period. Nonetheless, estimated Gini coefficients based upon Santiago data (Table 4), are probably providing a partial picture of the distributive situation, as the regions of the country were undergoing an important economic progress by the late 1980s. As a matter of fact, the relative worsening in Gini coefficients in the late 1980s is not supported by the national evidence presented in Table 5 which indicates a strong distributive improvement, especially after 1983/84.

During the 1980s there was an increasing array of monetary and non-monetary subsidies targeted to the poor[24], whose effects are not necessarily reflected in labor incomes and, thus makes the interpretation of many distributive indicators controversial. As Riveros & Weber (1987) have shown, the effect of considering the various subsidies into the income definition, makes a notable difference with regard to measurement poverty. Overall, however, the negative social effects of the adjustment of the 1970s and the crisis of the early 1980s were high in distributive terms. To a large extent, this result was due to the absence of an adequate social-safety-net to alleviate the situation of the unemployed and the poor; moreover, in addition to the lack of enough reactive social policies aimed at protecting the poor during the transition, there was an absence of proactive policies aimed at facilitating the labor reallocation process. These failures created unnecessary social friction, and may have delayed the adjustment process due to the reduction in credibility and sustainability. The lack of appropriate social policies during the 1970s and early 1980s, probably obeyed to the assumed perception that the adjustment process was going to be shorter than it actually was, making unnecessary a significant social reform. In turn, this view can be traced to the lack of precedents for an adjustment case of the magnitude of that seen in Chile.

In 1976-1979 the need for lower inflation and fiscal discipline led to a severe decline in social outlays, particularly in health and education (Box 2) which apparently magnified the impact of the adjustment on the prevailing poverty situation. After 1980, the observed increase in social outlays (Col (4) Table 4) is associated with the privatization of the social security system and unemployment subsidies[25], and it does not necessarily mean that there were more resources devoted to deal with

[24] This included not only the unemployed --for whom a whole variety of alternative subsidies were created-- but also for the groups such as the elderly, women, children attending public schools, etc.

[25] Unemployment subsidies are included in Box 2 in the category of "Other" fiscal social expenditures. These figures indicate an important decline in value since 1989, as a consequence of the elimination of massive unemployment.

structural poverty[26]. This is clearly reflected in the series included in Box 2, which reveal the significant increase in the importance of social security payments as a proportion of the social fiscal spending and GDP. In turn, the declining social outlays after 1985 are associated with fiscal restraint and with improvement in some labor market outcomes, particularly the decline in open unemployment[27]. This decrease in the level of social outlays took place in combination with a better targeting of the poorest groups, facilitated by the early 1980s reforms of the social sector implemented during the early 1980s --particularly the decentralization and the creation of specific subsidies . In general, however, problems of access and financing of the health and education systems are still of paramount importance in Chile, challenging policy makers with the need of making the economic program distributionally more equitable and politically more sustainable.

With regard to poverty, by the end of the 1980s the proportion of poor households was estimated to be as high as 40 percent. This indicator, although disputable in terms of customary methodological grounds, reflects the severity of the productive shock of the early 1980s combined with stubborn labor market disequilibria. It is important to note that subsequent measures of the absolute poverty level in Chile, has shown a significant decline, as the economy continues in a high-growth path and the social policy has continued refining its targeting methods (Pardo, 1993).[28] An important note to make to this respect is that although there has been a clear improvement in poverty (as for instance revealed by the income share of the lowest quintile (Table 5), this has also been the case of the share of the highest quintile, particularly up to 1987. Therefore, the adjustment experience has led to a deterioration of quintiles 2, 3 and 4 in terms of their income sharing. This gives support to the claim that the middle class has been the one most damaged from a welfare viewpoint due, particularly for having it lost access

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[26] The privatization of the social security system implied a notable increase in fiscal spending, due to the need of paying out the commitments associated to the former system. The importance of social security outlays, as a proportion of the GDP, went from 2.5 percent in 1970, to 6.6 percent in 1992 (Box 2)..

[27] See, to this respect, the column "Others" in Box 2, which includes unemployment compensation outlays, and dropped from 3.4 percent of the GDP in 1985 to an only 1.2 percent in 1992.

[28] The CASEN (Chilean Socieconomic Survey) allowed to estimate the total poverty, including access to monetary subsidies. In 1987 there were a 38.2 percent of poor households, while in 1990 and 1992 that number notably declined to 34.5 percent and 27.7 percent respectively. The critical poverty (also called structural in the literature), which corresponds to those whose income does not reach the poverty line, and present unsatisfied basic needs, reached in the same years, 16.8, 13.8 and 9.0 percent respectively.

to the complex and fruitful system of subsidies existing prior to the economic reforms and thereuction and targeting of social expenditures.

4. LESSONS OF THE CHILEAN ADJUSTMENT EXPERIENCE

This section attempts to list the most important implications of the Chilean experience for other LDCs needing stabilization and adjustment. The leading argument is that this experience is generally applicable to other countries in the region but that the idea of simple replication is clearly inappropriate. Some crucial policy lessons and some broad policy guidelines taken from the chilean experience are helpful in designing adjustment packages in other countries. However, country-specific factors, and the positive effects of the recent wave of liberalization and globalization on reform prospects for any individual country, are key elements that should be taken into account before considering any direct application of the Chilean experience.

There are four general qualifications that must be taken into account in considering the pertinence of the chilean reforms for other experiences. (1) it is important to note that the chilean reforms were undertaken very early on, when world trends were still favorable to trade protectionism, and government intervention was felt indispensable to achieve growth and equity. The present wave of economic globalization and the almost undisputed leading role given to the private sector in any economic strategy, have totally changed that political scenario. This change allows for a higher political support, and a more sustainable economic program than the one applied in Chile in the 1970s and early 1980s. (2) all the available battery of lending programs and financial assistance from industrial countries and international agencies, which are now supporting the implementation of neoconservative structural changes in most LDCs, did not constitute a possibility to finance the cost of the transition in Chile; reforms were implemented in absence of a lending program for the purposes of introducing adjustment policies, particularly during the stabilization phase of the 1970s. (3) The chilean experience is particularly irrelevant for other countries with regard to the application of policies to ameliorate the social cost of the adjustment. The unavailability of a suitable lending program, and the practical irrelevance of it after the financial crisis, made the attainment of specific adjustment targets more difficult and probably more costly from a social viewpoint. (4) It is also important to consider that the Chilean experience did not have any precedent, this originating unnecessary elongations, mistakes, policy reversals and, at the end, higher adjustment costs. Naturally, countries currently undergoing economic reforms have the advantage of knowing the background of Chile and other countries which have had different degree of success regarding their reform experience.

On the other hand, the basic problems confronting the Chilean economy at the beginning of the 1970s, and at the outset of the 1980s, are still characteristics of other Latin American countries. Some, like Brazil, are suffering from persistent inflationary pressures and fiscal/monetary mismanagement, requiring profound stabilization programs. This is also the case of middle level-inflation countries such as Ecuador and Uruguay. For them, lesson of the Chilean experience--ratifying direct implications of economic theory-- is the unavoidable need for stabilization based upon standard fiscal and monetary policies, which must precede the adoption of structural adjustment measures. Today it is an accepted fact that before any productive restructuring led by the private sector can take place, a reduction in state intervention and the alignment of relative prices is indispensable. This principle also recognizes the fact that only in a free market environment it would be possible to attain an adequate supply response to policies seeking a resource reallocation towards expoandin economic sectors.

In other countries, such as Costa Rica, El Salvador and Peru, a comprehensive agenda of structural changes is underway, including a public sector reform and privatization of public enterprises, a financial sector reform and the adoption of export promotion policies, particularly through measures regarding the exchange rate and the fiscal side. In this connection, the Chilean economy provides an useful framework regarding the sequencing of policy measures and the priorities in designing a reform agenda. Jointly with other adjustment experiences of more modern fashion, such as those from Argentina, and Mexico, four fundamental policy lessons are consistent with the Chilean stabilization/adjustment experience, applicable to countries in either of the two situations (pre and post stabilization) aforementioned.

(1) There are usually two phases in adopting adjustment packages. This is important because a proper sequencing of stabilization and structural adjustment policies requires different policy instruments at different points in time. Also, because achieving the second phase require proper stabilization in place, allowing the price system to reflect the social cost of resources. During the first phase, standard fiscal and monetary policies are the key. Measures aimed at attaining a trade opening and at reducing the size of the public sector, are normally important in order to complement the stabilization agenda, while at the same time they constitute key signals for the private sector and a necessary preparation for the structural change. During the second phase privatization of public firms is one of the most important policy actions, requiring a financial sector reform to allow the capital market to allocate resources in alternative projects. At the same time, consolidation of the trade and financial opening up, decentralizing the social

sectors, promoting exports and introducing labor market flexibility are paramount measures in order to achieve a structural change in relative prices, production, employment and property.

(2) The adjustment process takes a very long time. The degree of political and social control is important, but not decisive, to success. As the Eastern Europe and Russia cases suggest, the availability of previous experiences and financial assistance is also important but not crucial in producing a shorter transition. There is a learning process for the population as a whole, and for the new entrepreneurial groups that will arise as a result of a more deregulated and competitive economic environment. And this process is necessarily time-intensive. Labor should also experience profound changes towards more modern unions, able to negotiate on more technical grounds; and labor reallocation from contracting to expanding industries --normally affected by significant skill mismatching-- must take place, raising questions about the effectiveness of the program in the meantime. Changes in all markets and the new regulatory policies needed by a market economy will also demand a substantial learning process. In addition to the natural slowness of the transition, it is important to realize that making mistakes and suffering policy reversals is unavoidable in any adjustment experience. This lengthens the adjustment process and makes it more difficult to attain the desirable political sustainability of reform programs. This problem goes necessarily beyond the economic dimension, needing broad political agreements which should exceed any specific administration.

(3) Apart from obvious equity considerations, social policies are paramount to gain political credibility and achieve sustainable economic reforms. Targeting the poor, introducing more efficiency to traditional social sectors, and creating decentralization towards local governments and specific groups, are paramount to reduce social costs in the presence of significant fiscal constraints. This aspect is still more important in considering that the middle class will necessarily be the major losser during the adjustment, particularly due to the greater fiscal stringency. In the chilean this was not a key concern in the 1970s, in the assumption that adjustment was going to be attained more rapidly than it actually was. Hence, this created significant difficulties which could be managed only in the particular political environment prevailing in Chile in 1973-90, but it notably diminished the political credibility needed to substantially encourage private investment.

(4) Labor market reforms are indispensable early in the program in order to attain a flexible responde in terms of interindustry labor mobility. Absence of appropriate reform lengthens the period in which the economy suffers from high unemployment. At the same time, deregulating the labor market is crucial to attain more flexibility, this being a crucial factor in Latin America, given the tradition of heavy government intervention in labor markets. However, as the Chilean experience suggests, it is

wrong to pursue the virtual elimination of typical policies and institutions, as job security, non-wage compensations, right to unionize etc. Such actions do not contribute to improve credibility, but do notably reduce any possibility of attaining union support. In this sense, it may be highly advisable to organize coalitions aimed at transforming traditional labor market policies in a way consistent with a modern adjusting economy.

5. SUMMARY AND CONCLUSIONS

A series of stabilization policies, which implied --in addition to standard macroeconomic policies-- reducing the economic size of the State, deregulating the product and factor markets and opening the economy to foreign trade were of paramount importance in Chile during the 1970s. After the financial crisis of the 1980s, the Chilean economy underwent another wave of significant structural adjustment policies, the success of which was partly expedited by the economic reforms carried out in the late 1970s and early 1980s. The post-crisis policy was characterized by the achievement of significant real devaluations, a far reaching privatization, significant reforms in the social arena, the promotion of non-traditional exports, and financial policies to deal with both the external debt problem and the need of increasing investment. The results of the adjustment process in terms of the labor market were dramatic: open unemployment and real wages suffered severe dislocations during the 1970s and 1980s, due to both the stabilization phase and the financial crisis. In general, the adjustment involved substantial social costs, which were relatively well cushioned in the late 1980s by the targeting of fiscal social expenditures to the poor, but could have been further reduced were more proactive and reactive social policies used more extensively and earlier during the adjustment process.

The Chilean experience indicates that a sustainable adjustment process takes a long time, and that the distinction between the stabilization and the structural adjustment phases is a crucial one with regard to sequencing and the adoption of optimal policy instruments. It also indicates that liberalizing the labor market, through politically sustainable reforms, is crucial in flexibly achieving the necessary inter-industry labor mobility. Adequate proactive and reactive social policies, in the context of fiscal constraints, and aimed at protecting the poor, are fundamental not only on equity grounds, but also to attain program credibility. Overall, replication of the Chilean experience in detail is not a reasonable prospect for other countries, not only because of the particular political conditions o each case, but also because of the timing and the very different international environment prevailing for current adjustment efforts relative to those which Chile confronted.

Table 1

Chile : Macroeconomic Indicators

	GDP Growth (1)	Output Growth (T) (2)	Output Growth (NT) (3)	CPI Infl. (4)	M1 Growth (5)	Gross Inv. (6)	Fiscal Def. (7)	C.Acc. Def. (8)	Real Exch. Rate (9)
						--- (Percent of GDP)---			
1970	2.1	1.4	2.9	32.5	66.2	16.4	2.7	-1.2	38.5
1971	9.0	9.2	8.8	22.1	113.4	14.5	10.7	-1.9	35.3
1972	-1.2	-0.8	-1.1	260.5	151.8	12.2	13.0	-4.0	36.7
1973	-5.6	-7.3	-3.7	605.1	362.9	7.8	24.7	-2.7	56.7
1974	1.0	6.6	-0.4	369.2	231.2	21.2	10.5	-2.6	83.8
1975	-12.9	-16.6	-8.4	343.3	257.2	13.1	2.6	-6.8	100.0
1976	3.5	5.3	1.6	197.9	189.4	12.8	2.3	1.5	91.5
1977	9.9	7.8	9.4	84.2	113.5	14.4	1.8	-4.1	83.5
1978	8.2	4.5	9.6	37.2	65.0	17.8	0.8	-7.1	101.6
1979	8.3	7.0	10.0	38.9	57.8	17.8	-1.7	-5.7	105.9
1980	7.8	5.5	10.0	31.2	64.0	21.0	-3.1	-7.1	94.0
1981	5.5	3.8	5.4	9.5	-3.8	22.7	-1.7	-14.5	74.8
1982	-14.1	-11.2	-10.8	20.7	7.3	11.3	2.3	-9.5	81.1
1983	-0.7	0.5	-6.1	23.1	27.7	9.8	3.8	-5.6	98.1
1984	6.3	7.9	5.3	23.0	12.1	13.6	4.0	-10.7	100.8
1985	2.4	2.5	2.4	26.4	11.3	13.7	6.3	-8.3	123.0
1986	5.7	6.7	5.0	17.4	41.4	14.6	2.8	-6.5	139.9
1987	5.7	3.5	6.6	21.5	9.8	16.9	-0.1	-4.6	143.5
1988	7.4	6.9	7.7	12.7	17.7	17.0	-1.7	3.0	149.9
1989	10.0	8.4	11.0	21.4	13.2	25.5	-1.8	-2.1	146.4
1990	2.1	0.7	3.0	27.3	17.5	24.7	-0.8	-1.9	151.9
1991	6.1	5.0	6.7	18.7	54.0	22.2	-1.6	-1.7	147.2
1992	10.3	7.1	12.0	12.7	16.8	24.1	-2.3	-2.0	132.1
1993	6.0	2.3	7.9	12.2	26.4	26.2	-2.0	-5.0	131.0

Notes: T=Tradable; NT= Non-Tradable; Inv= Investment; C.Acc.= Current Account; Def=Deficit. Tradables includes agriculture, fishing, mining and manufacturing. Non-tradables includes construction and services. CPI inflation and M1 growth correspond to the December to December change in the variable. The Real effective exchange rate is the real multilateral exchange rate in terms of the wholesale prices of trading partners and Chile's cpi.
The average ratio investment to GDP during 1960-69 was 14.9%.

Sources: (1), (2). (3), (5), (6), and (7), Indicadores Economicos y Sociales, 1960-85, Banco Central de Chile (1987), IBRD: Chile's Country Economic Memorandum (1990) and Ministry of Finance: Estado de la Hacienda Pública (1993) (fiscal deficit since 1989); (4), (Cortazar & Marshall (1979);(6) and (8), Corbo (1985), IMF International Financial Statistics and Comentarios sobre la situación económica 1994; U. of Chile, Macroeconomic Chapter (P.-Mujica and M.-Basch) (9), Cottani (1987) & IDB Progreso Económico y Social an Améroca latina 1994.

Table 2
Chile: External Sector (b)

	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
1. External Debt															
(a) Total	8.49	11.80	15.50	17.10	17.40	18.90	19.30	19.40	19.10	17.60	16.30	17.40	16.40	18.30	19.20
Interest	0.67	0.93	1.46	1.92	1.75	2.02	1.90	1.89	1.70	1.60	1.70	1.92	1.81	1.86	1.50
(c) Debt/Exports (%)	2.70	2.40	4.10	4.60	4.60	5.20	5.10	4.60	3.70	2.51	2.00	2.09	1.84	1.83	2.08
(d) Debt/GNP (%)	0.40	0.40	0.50	0.80	1.00	1.10	1.40	1.30	1.20	1.10	0.90	0.64	0.52	0.47	0.47
2. Exports(FOB)															
(a) Traditionals	2.16	2.62	2.18	2.12	2.34	1.96	2.12	2.10	2.60	3.85	4.82	4.59	4.39	4.22	3.98
(b) Non-Traditional	1.68	2.09	1.66	1.58	1.50	1.69	1.68	2.10	2.62	3.20	3.26	3.72	4.54	5.27	5.22
(c) Total	3.84	4.61	3.84	3.71	3.83	3.65	3.80	4.20	5.22	7.05	8.08	8.31	8.93	9.99	9.20
3. Imports(CIF)															
(a) Consumer Goods	1.33	2.07	2.73	1.48	1.02	1.04	0.75	0.75	0.90	1.01	1.49	0.8	1.13	1.69	1.90
(b) Capital Goods	0.95	1.27	1.45	0.70	0.39	0.60	0.65	0.74	1.10	1.37	1.95	2.13	1.84	2.57	3.04
(c) Total Imports	4.71	6.15	7.32	3.69	2.85	3.29	2.96	3.10	3.99	4.83	6.50	7.02	7.45	9.46	10.54
Trade (1980=100)	118.50	100.00	84.30	80.40	87.50	83.20	78.50	82.00	77.00	93.30	92.10	82.56	82.09	81.31	74.21

Note: Figures are expressed in billions of current US dollars.
Traditional exports include copper and mining.
Non-traditional exports are agricultural and industrial products.

Sources: (1).(2) and (3): Boletin Mensual. Banco Central de Chile and International Financial Statistics. Yearbook. FMI, 1994
(4): Corbo & Sturzenegger (1988).

Table 3
Chile: Real Wages
(Index: 1980=100)

	Source: INE			Source: University of Chile			
	Minimum Wage (1)	**Average Wage (2)**	**Manuf. Wage (3)**	**Inf. Sector Wage (4)**	**Labor Cost (US$) (5)**	**Unemployment Rate (6)**	**Skilled W. Unskill W. (7)**
1970	81.0	109.7	97.1	124.1	0.69	5.7	116.1
1971	106.8	134.1	106.6	133.7	1.09	3.8	136.7
1972	101.7	119.0	101.2	138.4	1.06	3.1	113.4
1973	46.2	73.1	68.4	99.0	0.58	4.8	95.0
1974	90.6	70.2	62.2	94.5	0.53	9.4	83.0
1975	105.1	62.5	58.3	77.3	0.43	15.5	86.3
1976	100.1	78.9	78.6	77.0	0.60	20.6	101.1
1977	84.6	79.9	78.6	80.3	0.88	19.2	111.7
1978	97.4	85.0	87.4	82.4	1.06	18.0	119.4
1979	98.3	92.0	94.2	102.6	1.28	17.2	101.2
1980	100.0	100.0	100.0	100.0	1.45	16.5	100.0
1981	111.0	108.8	115.5	120.4	2.42	15.1	98.6
1982	122.2	108.6	110.7	126.6	2.08	25.7	105.3
1983	93.2	97.0	102.9	80.9	1.30	30.1	118.5
1984	82.1	97.1	99.0	77.8	1.13	22.9	115.0
1985	74.3	93.0	97.1	75.6	0.77	20.9	98.1
1986	78.8	95.0	101.9	64.4	0.78	18.0	103.4
1987	66.9	93.1	103.2	63.1	0.81	15.2	103.3
1988	74.2	98.6	109.8	64.3	0.92	13.1	104.0
1989	80.1	100.4	111.8	65.5	0.98	10.1	109.3
1990	87.9	104.7	116.1	89.4	1.11	9.0	110.3
1991	101.0	109.9	123.8	88.4	1.28	6.5*	93.0
1992	108.1	118.4	129.7	108.4	1.33	4.9*	88.0
1993	119.6	119.0	133.1	129.5	1.42	4.6*	92.6

Note: (1): :two legal minimums existed in 1970: for white and blue collar workers. The latter is used here.
(2): Average Wages .National Yearly Averages for all skills.
(3): Manufacturing sector wages. Yearly Average for all skills
(4): Urban Informal sector wage. proxied by the average hourly income of self employed workers with less than 8 years of formal schooling; it has also been reported as "unskilled wage" in the free sector of the economy (informal sector). Figures correspoind to May of each year.
(5): Labor Costs corresponds to the wage of unskilled labor in the manufacturing sector. plus fringe benefits. expressed in hourly (nominal) US dollars.
(6) :* indicates that the source is the National Bureau of Statistics (INE).
(7): The skilled wage correspond to blue and white collar workers employed in the formal sector. with 8 or more years of schooling. The unskilled wage corresponds to that reported in (4).

Sources: (1). (2) and (3): INE; (4) Paredes (1987) & University of Chile Labor force surveys: May of each year; (5) Riveros (1988) ; (6) University of Chile: (7) Paredes (1987).
All the wage data have been deflated by the average corrected CPI based in INE. Yañez (1979) and Cortazar-Marshall (1979).

Table 4
Chile: Social Indicators

	Gini Coefficient (1)	Gini Coefficient (2)	Income Share of 40% Poorest	Fiscal Social Expenditure (% of GDP)	Per Capita GDP (1976 US$)
1960	0.4590	0.4012.	13.59	n.a.	n.a.
1965	0.4750	n.a.	12.87	n.a.	n.a.
1968	0.4980	n.a.	11.70	n.a.	1,114
1970	0.5010	0.4345	11.50	n.a.	1,137
1974	0.4499	0.4232	n.a.	11.08	1,090
1975	0.4710	0.4127	12.78	10.30	0,933
1976	0.5380	0.4886	n.a.	9.99	0,950
1977	0.5260	0.4762	n.a.	10.56	1,026
1978	0.5197	0.4662	n.a.	10.16	1,091
1979	0.5179	n.a.	n.a.	9.25	1,162
1980	0.5257	n.a.	10.88	10.29	1,231
1981	0.5220	0.4788	11.24	12.80	1,277
1982	0.5390	n.a.	9.95	15.76	1,078
1983	0.5420	n.a.	10.07	15.10	1,052
1984	0.5550	0.5151	9.33	15.40	1,100
1985	0.5320	0.5011	10.13	15.12	1,108
1986	0.5390	0.4997	10.00	14.30	1,230
1987	0.5310	0.4950	10.22	13.97	1,271
1988	0.5431	0.5012	10.91	14.01	1,312
1989	0.5523	0.5001	11.61	14.03	1,442
1990	0.5422	0.4987	11.72	14.02	1,516
1991	0.5391	0.4967	11.84	14.46	1,599
1992	0.5340	0.4951	12.01	14.70	1,760

Notes:
(1) Estimates based on total family income, representing the Greater Santiago Area.
(2) Estimates based on per capita family income, representing the Greater Santiago Area.

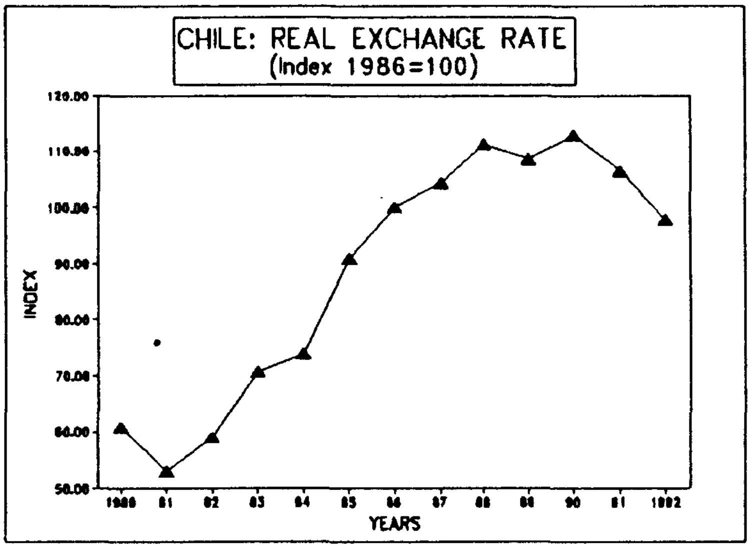
Sources: (1), (2) and (3): Riveros & Weber (1987); (4): Torche (1985) and unpublished data; (5): World Tables, The World Bank

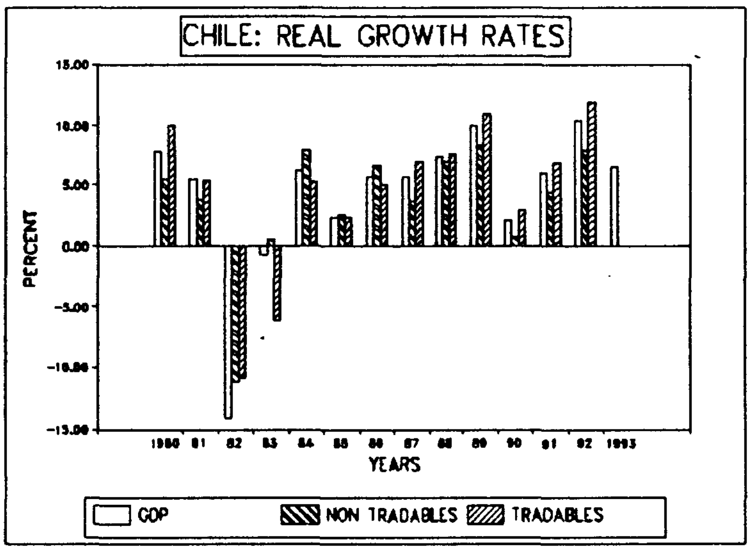
Table 5
Chile: Income Distribution 1980-91
(percentages)

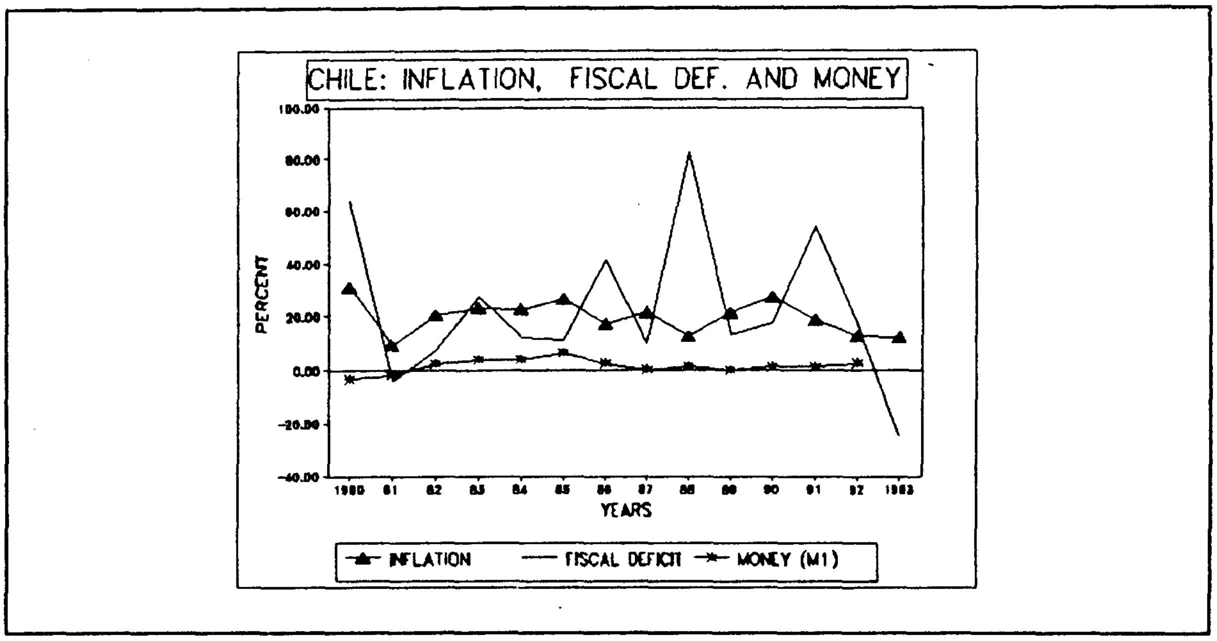
Quintiles	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
1	4.6	4.2	3.2	3.4	3.8	4.1	4.0	4.2	4.6	4.7	4.5	4.7
2	9.0	8.5	8.2	8.3	7.7	8.3	8.0	7.8	8.2	8.9	8.5	8.3
3	12.7	12.7	12.0	11.8	11.7	11.9	11.6	11.5	12.6	12.8	12.2	12.3
4	18.7	19.4	19.3	19.1	18.1	18.6	18.3	18.2	19.1	19.6	18.8	17.8
5	55.0	55.1	57.3	57.5	58.7	57.1	58.1	58.4	55.5	53.9	56.0	56.9

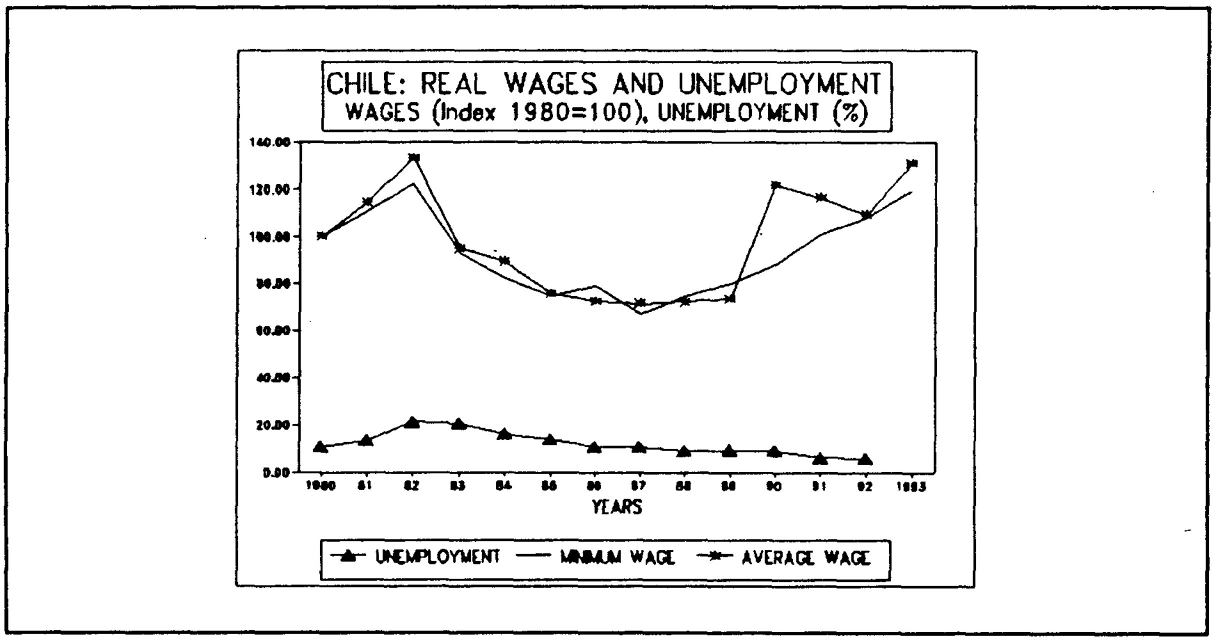
Figures correspond to the share of the total family income in the total national income. The Quintile distribution was prepared on the basis of the per cápita family income. Data corresponds to the national household survey of the University of Chile.

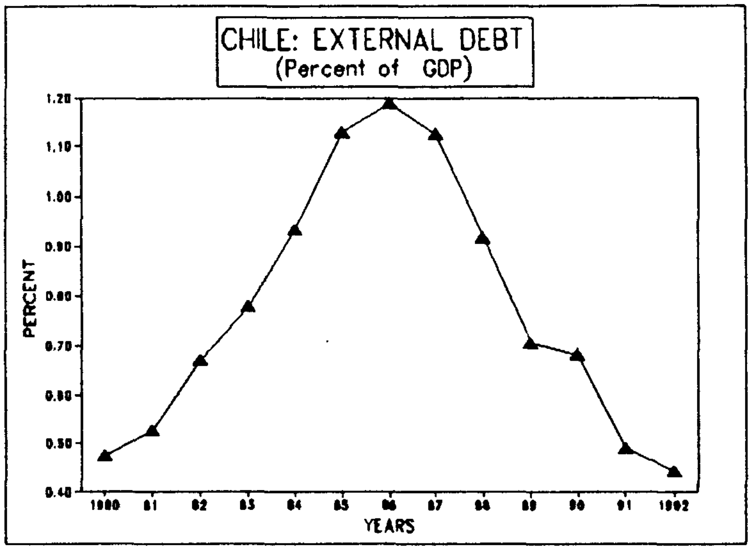
Source: Unpublished data processed by M. Bash and J.Yanez (University of Chile-Department of Economics).

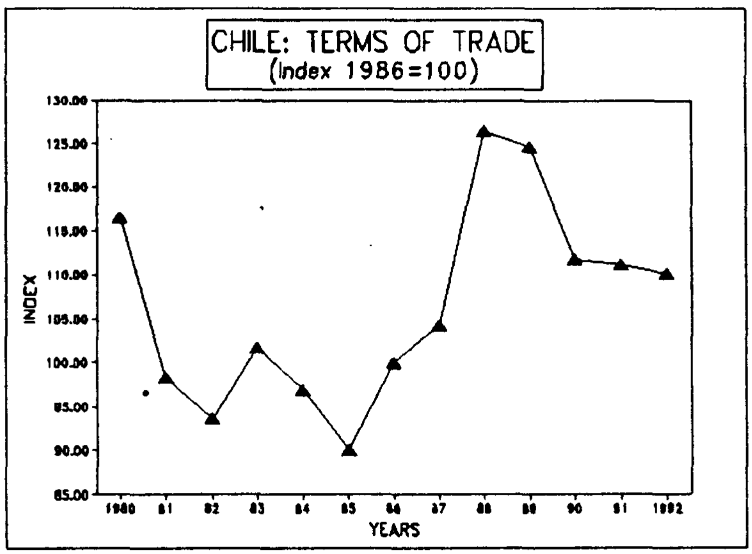

CHILE: REAL EXCHANGE RATE
(Index 1986=100)
INDEX
YEARS


CHILE: REAL GROWTH RATES
PERCENT
YEARS
GDP
NON TRADABLES
TRADABLES


CHILE: INFLATION, FISCAL DEF. AND MONEY
PERCENT
YEARS
INFLATION
FISCAL DEFICIT
MONEY (M1)


CHILE: REAL WAGES AND UNEMPLOYMENT
WAGES (Index 1980=100), UNEMPLOYMENT (%)
YEARS
UNEMPLOYMENT
MINIMUM WAGE
AVERAGE WAGE


CHILE: EXTERNAL DEBT
(Percent of GDP)
PERCENT
YEARS
1.20
1.10
1.00
0.90
0.80
0.70
0.60
0.50
0.40
1980
81
82
83
84
85
86
87
88
89
90
91
1992


CHILE: TERMS OF TRADE
(Index 1986=100)
INDEX
YEARS
130.00
125.00
120.00
115.00
110.00
105.00
100.00
95.00
90.00
85.00
1980
81
82
83
84
85
86
87
88
89
90
91
1992

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